AUGUST 2014 NEWSLETTER

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EMPLOYER LIABILITY FOR CRIMINAL ACTS OF THEIR EMPLOYEES

FIRM ANNOUNCEMENTS:

A. Joseph R. Pozzuolo, Esquire will be a speaker at a CPE seminar sponsored by the Montgomery County Society of CPA's on Wednesday September 10, 2014 @ 9:00 a.m. at the Cedarbrook Country Club, 180 Penllyn Blue Bell Pike, Blue Bell, PA 19422.

Please contact Diane McLeer @ DMcLeer@Janney.com

B. **FREE ONLINE CLE/CPE CREDITS:**

Pozzuolo Rodden, P.C. is pleased to announce the opportunity to obtain free CPE/CLE credits by viewing the LawLine webcast courses previously taught by

Joseph R. Pozzuolo and/or Jeffrey S. Pozzuolo titled "The Negotiation and Documentation of Commercial Financing Documents Including the Use of Convertible Loans With Put and Call Options", "How Middle Income Families Should Plan for Retirement Including Ethics" and "The Fundamentals of Starting a Business".

***How Middle Income Families Should Plan for Retirement- http://bit.ly/ZvgNbr**

***The Fundamentals of Starting a Business- http://bit.ly/13Q8dei**

***The Negotiation and Documentation of Commercial Real Estate Loan Documents- http://bit.ly/17jfXSN**

Any problems, please feel free to contact Chrissy @ chrissy@pozzuolo.com

Also, each of these seminars can be viewed without receiving credit on the internet at "Pozzuolo Rodden, You Tube" or at www.pozzuolo.com.

QUESTION OF THE MONTH:

SHOULD I INCLUDE A "SHOTGUN/ESTRANGEMENT" CLAUSE IN MY BUY-SELL AGREEMENT?

Answer-See Page 5 of this Newsletter

EMPLOYER LIABILITY FOR CRIMINAL ACTS OF THEIR EMPLOYEES

Under Pennsylvania law, an employer can be held liable for the criminal acts of its employees under certain circumstances. Pennsylvania Courts have allowed claims for negligent hiring, retention and supervision of employees relating to an employee's criminal acts while on the job. Employers must take precautions to protect themselves and their businesses from liability for their employees' illegal acts. Accordingly, it is important for employers to know whom they are hiring and make sure they have adequate supervision in place to prevent harm to others caused by their employees.

The Restatement of Torts (Second) § 317 implies a duty on employers to supervise and control the actions of their employees. This requires an employer to exercise a duty of reasonable care to control an employee from committing harmful acts outside the scope of his employment which could intentionally harm others if: (1) the employee is on the premises of the employer or using property of the employer; and (2) the employer knew or should have known that it was

necessary he exercise control over this employee. Furthermore, agency law principles further support a finding of employer liability because, under agency law a principle can be liable for the acts of his servant if the principal fails to exercise due care and the qualities of the servant make him likely to harm others during the course of his employment. See the Restatement (First) of Agency § 213.

In, McBride v. Hershey Chocolate Corp., the Superior Court of Pennsylvania considered this issue. In McBride, one employee intentionally injured another employee by dousing him with steam and hot water from a hose during the workday. The Court found there was ample evidence that the attack was based on a personal animosity between the two employees that had been building up over the years. The Court held that because the attack on the employee was personal, the Workers Compensation Act would not cover the victim's injuries, but the Court further held that the victim could bring a civil suit against his employer to hold the employer liable for his injuries.

The McBride Court held that under Pennsylvania law, the employer has to exercise reasonable control over its employees to prevent them from intentionally harming others, if the employer knows or has reason to know of the need for that control. The Court found the employer was aware of the animosity between the employees and that the attacker had previously attempted to instigate fights with the victim, because the victim had attempted to address the situation with his supervisors numerous times prior to the attack. Accordingly, the Court found that the employer could be held liable to the victim for negligence since the employer had knowledge of the situation and failed to take any steps to prevent the harm to the victim.

Based on McBride, an employer must take steps to address aggression and the possibility of violence in the workplace, if the employer knows or has reason to suspect that that any violence and/or harm could occur.

However, this type of employer liability can extend far beyond fights that break out between employees. Recently in Doe v. Eckerd Corporation, et al., the Court of Common Pleas of Lawrence County, Pennsylvania, found that an employer could be liable to third party minor children who were molested on a construction site by the employer's employee. In Doe, the Court found that there was enough evidence that a jury could find the employer knew or should have known that its employee was acting inappropriately with minor children because subcontractors on the construction site testified that often times children were present on the job site, and the employee would take them into his trailer. The Court found that if the employer had frequently visited and supervised the job site it would have known of the situation developing. The Court stressed the importance of employers adequately supervising their employees and job sites to protect third parties against harm caused by their employees.

Another issue in Doe that led to employer liability is that the employee in question was a registered sex offender, before he began his employment with the employer. The employee was hired on June 7, 2010 and terminated on February 2, 2011 when the employer discovered the employee was a registered sex offender. However, this information was available to the employer at the time of the employee's hiring and could have been revealed with an adequate background check. This type of liability for criminal acts stresses the need for employers to use background checks and properly supervise their employees to protect third parties from potential

harm.

In Pennsylvania, certain types of employers, such as those in the fields of education and law enforcement, are required to check the criminal backgrounds of their employees. Other employers may require a background screening of applicants for their criminal history. However, this use of criminal records by employers when making employment decisions is governed by Pennsylvania law. Pennsylvania statute 18 Pa.C.S. § 9125 expressly allows employers to use an applicant's criminal history records for the purpose of deciding whether to hire that applicant, however, it states that felony and misdemeanor convictions may be considered by employer ***only to the extent to which they relate to the applicant's suitability for employment in the position for which he has applied.***" (emphasis added). Additionally, under the statute, the employer must notify the applicant in writing of its decision if the decision is based on the applicant's criminal history record. Employers must be careful to comply with these statutory requirements when using criminal history records in making hiring decisions. Additionally, it is important for employers to remember that if a charge is still pending against an applicant he is presumed innocent while the charges are pending.

Another concern that an employer must be aware of is possible discrimination claims that can arise from denying or terminating employment based upon a person's criminal history records. While consideration of an applicant's arrest and criminal records is not prohibited by federal law, the Equal Employment Opportunity Commission ("EEOC") has published enforcement guidelines to help employers use this information in a non-discriminatory manner, otherwise, an employer could face liability for discrimination claims made under Title VII.

The EEOC stresses the importance of differentiating between arrest and conviction records. The EEOC warns that an arrest does not establish criminal conduct has occurred. However, following an arrest an employer may make an inquiry to determine if the conduct underlying the arrest would make the individual unfit for employment. A conviction however is sufficient to demonstrate the criminal conduct occurred. However, the EEOC is concerned with disparate impact and disparate treatment of minorities under Title VII when basing employment decisions on criminal history records. For example, a violation of Title VII can occur if an employer treats the criminal history information differently for different applicants based upon their race or religion or if the employer has a neutral policy which may disproportionately impact minority individuals protected under Title VII.

Additionally, an employer must make sure not to violate the Fair Credit Reporting Act if the employer wants to obtain an applicant or employee's criminal history from a consumer reporting agency. Therefore, the employer must obtain permission from the applicant or employee before asking for the criminal history report, must provide a copy of the report to the applicant or employee and provide a summary of his or her rights under the Fair Credit Reporting Act before taking a negative employment action and must send the applicant or employee notices if it decides to take a negative employment action based upon the report.

There are many legal issues that may arise and leave employers liable relating to their hiring, retention and supervision of employees. Accordingly, if you wish to further consult with one of our experienced attorneys regarding these matters, please do not hesitate to contact us.

QUESTION OF THE MONTH:

SHOULD I INCLUDE A "SHOTGUN/ESTRANGEMENT" CLAUSE IN MY BUY-SELL AGREEMENT?

A "shotgun or estrangement clause" ("Shotgun") is an important clause to consider for buy-sell agreements as it permits for a clean entity break up when one owner is not pulling his weight, two owners just do not see eye to eye, one owner desires to retire or move into other business or personal opportunities, or for any other variety of reasons decides to have a business breakup. It permits one party to invoke such clause without the need for long drawn out negotiations that may put salt in old wounds. However, there are times when it is appropriate and times when it will lead to unfair and one sided circumstances. This short article addresses the situations when a shotgun clause is favorable, when it is not, and some steps that can be incorporated to minimize certain common abuses.

What is a Shotgun Clause:

In short, a shotgun clause is one where one owner (the "Initiator") has the right or option to either make an offer to sell his interest to or purchase the other owner's interest (the "Reactor") at a certain price. For simplicity, assuming the Initiator exercises the option to sell his interest, the Reactor then has a certain time period in which to accept or reject the offer and purchase the Initiator's interest at the proposed price. If the Reactor rejects the offer, the Reactor must sell his interest to the Initiator at the same price or any pre-negotiated variation of the same. If the Initiator's price is too high, the Reactor will sell his share receiving a premium, but if the Initiator's price is too low, the Reactor will purchase the Initiator's shares at a discount. A shotgun buy out provides a clean way to avoid break up without a long drawn out chaotic entity dissolution involving attorneys, accountants, court proceedings, expenses and costs.

When Shotgun Clauses are Appropriate:

Shotgun clauses have their time and place. They are appropriate for many 2 to 3 person closely held businesses especially when the following are present:

- No Owner is Financially Dominant: If no owner has the right to financially dominate the other, then a shotgun clause would be appropriate. If one has the ability to buy the other out, the financially able owner, the Initiator, may make a heavily discounted offer and purchase the other owner's interest at such discount knowing that the Reactor owner cannot afford it. Even if one owner has a net worth of $100 million and the other only $5 million, financial dominance depends on the less wealthy owner's ability to buy the wealthier owner out, not on their relative net worths. For example, in a $5 million business with equal owners, a shotgun clause would work, but if he has a 20% interest in a $20 million business, then it is not likely the less wealthy owner can pay $16 million to

buy the wealthier owner out.

- Each Owner has Expertise/Desire to Continue the Business Alone: Both owners must have the desire and expertise to manage and operate the business. If one owner does not, the other owner will sense this and make a discounted offer knowing the Reactor owner does not want to purchase and manage the day to day affairs of the business.

- Limited Number of Owners: Implicitly, the more owners one person has to buy out, the greater he will have to pay in relation to the value of his own interest. For instance, if there are five owners of a $10 million business and if one individual wants to buy the other four owners' interest out he needs to pay $8 million whereas they only need to pay $2 million. This allows the other owners to indirectly have a financial dominance over one particular owner when exercising their option, as a group, to sell or buy. Further, the more owners, the more likely there will be one or two that do not want to manage the business themselves or have no expertise in how to operate and manage the business. As a general rule, absent a clear financial dominance or one owner being the rainmaker for the business, a shotgun clause buy out should work for up to three owners in most situations.

When Shotgun Clauses are Not Appropriate:

While many closely held businesses will meet the above criteria, there are certain situations where if present, a shotgun clause may permit one owner to "bully" another by allowing the Initiator to purchase the Reactor's interest at a discount or sell his interest at an unfair premium:

- One Owner is Financially Dominant or has Substantial Control: As stated above, if one owner is financially dominant, he may bully the other owner into accepting a low price. Further, if the owner has substantial control, the owner could choose to exercise a shot gun buy out at a low price knowing the other owner cannot afford the shotgun buy out price. For instance, if there is a 80/20 ownership split for a business worth $10 million, the 80% owner only needs to pay $2 million to purchase the 20% owners out, while the 20% owner would need $8 million to purchase the 80% owner out. Since $8 million in financing may be much harder to obtain than $2 million, the 80% Initiator owner may be able to only offer $1.5 million for the 20% Reactor owner's interest.

- One Owner Does Not Want to or is Unable to Run the Business: If one owner always wants to be a silent owner, lacks the expertise to manage the business, desires to remain retired or is disabled, it may not be in the interest of such owner to include a shotgun clause.

- Too Many Owners: While it depends on the particular circumstances, a shotgun clause is not recommended if there are more than two or three owners or factions of owners since it adds too much confusion, and leads to an increased risk of a group of financially dominated owners.

- When One Owner is More Vested in the Business: If one owner is more vested in a business emotionally through family history or the business is his pet project, or is his sole source of income, or he has contracts with his related or controlled business, that owner may be bullied into paying a premium to keep access to these emotional and financial interests and ties. For instance, if an owner has a related business receiving $3 million of income from the entity that would disappear if his interest was sold, he may be willing to pay a $1 million premium to keep that contract and source of income or emotional ties.

- Voting or Profit Rights Differ from Proportionate Ownership Percentage: When voting and profit rights differ from strictly proportionate equity ownership, a shotgun clause may not work. For example if two owners own a business 50/50, but one has 60% of the voting rights whereas the other has 60% of the profits interest, an offer of $500 per each one percent of interest does not compare "apples to apples" since each partner's interest provides a different set of rights. Each owner should have a common set of interests.

- Access to Information: If one owner manages the day to day business affairs and the other is a silent owner, the managing owner will inherently have greater access to information. While it may breach his legal fiduciary duty, he may learn about new business opportunities or risks and fail to disclose them. He may sell his interest to the silent owner if he learns of a new business risk or may purchase the silent owner's interest at its current value if he learns of a new business opportunity that will increase the future value tremendously.

Steps to Avoid Abuse of a Shotgun Clause Even in Non-Ideal Situations:

Last, since nothing stays the same and circumstances change, certain steps can be taken to counter financial dominance, too many owners and lack of access to information.

- Initiator Pays in Cash While Reactor Pays by Note: One way to avoid a financially dominant owner from bullying a Reactor owner is to require the Initiator to pay in immediate available funds at the Closing and allow the Reactor to pay by a note payable over a number of years with a prenegotiated reasonable rate of interest. Then, if the Reactor does not have the immediate funds or cannot obtain appropriate financing, the shotgun clause automatically provides for expressed financing through the note at a predetermined minimal interest rate to help level the playing field.

- Adding a Premium to the Initiator's Purchase: Since a financially dominant Initiator would offer a lower price hoping to purchase the Reactor's interest cheaply, the Reactor could be given the right to purchase at a prenegotiated discounted offered price whereas the Initiator would have to pay this price plus a premium to help negate such discount. For instance, if the Initiator offers a co-owner $5 million for an interest worth $6 million, the Reactor could purchase the Initiator's interest for $5 million or any variation of the same, but the Initiator would be required to pay the full Fair Market Value predetermined offer price or formula determined Fair Market Value multiplied by 120%, or $6 million.

- The Price Includes a Component to Adjust Post-Sale Growth: To defend against asymmetrical information, the purchase price paid by the Initiator could be payable over a number of years and could be adjusted annually based on post-sale annual performance. For instance, the final price could be increased/decreased X% for each 10% increase/decrease in income for the trailing two years. This avoids asymmetrical information issues as the selling owner has an interest in the continued profitability of the business without having full risk.

- Multiple Owner Buyouts: Instead of requiring one owner to buyout all four other owners, the agreement may enable a particular owner (or group of owners) to effect a shotgun clause against particular owners where the initiating owner sets the price, and the reacting owner decides who sells his interest. This may be a way to buy out a problematic owner without a complete dissolution or long legal battle.

Conclusion:

A shotgun clause is an important and essential addition to many buy-sell agreements for closely held businesses. There are certain times when they are appropriate and not appropriate. Further, certain protections should be considered even if the current situation looks favorable to a shotgun clause as a current situation may change as owners' fortunes, health interests and circumstances change. However, a shotgun clause is an essential business planning tool that each closely held business should consider and review from time to time.

- If there are any legal questions you would like this office to answer in the future, please email the question to us at info@pozzuolo.com. Each month, the question with the most relevance to our privately held business clients, advisors, and friends will be answered in our monthly newsletter. The questions can relate to any of the areas practiced by this office including business planning and transactions, corporate law, commercial litigation, employment law and litigation, commercial real estate and development, construction law and litigation, estate planning, estate administration, tax and pension law, family law litigation.

PUBLICATIONS

All of the following professional publications and past newsletters written by attorneys of this office are available by clicking here: http://pozzuolo.com/Pubs Articles.shtml

Corporate/Tax Articles

- Bankruptcy - How To Prevent It And How To Cope With It Should It Happen To Your Business
- Deferred Compensation Rewards And Retains Key Employees
- Design Buy-Sell Agreements For Maximum Utility
- How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend
- How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations
- How To Look, Act And Sound Like A Professional Corporation

- How to Structure a Suitable Buy-Sell Agreement
- How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool
- Money Purchase Pension Plan Falls Out Of Favor
- Protecting A Client's Business From Unfair Competition Using Restrictive Covenants
- Structuring Loans From Qualified Plans - How To Handle The Strict Tax Rules
- What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs
- Why An Employment Contract Is Mandatory

Estate Planning Articles

- Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples
- College Funding Tool Offers Estate Planning Advantage
- Diversify Strategies For An Effective Estate Plan
- Divorce and Estate Planning
- Divorce Raises The Need For Performing An Estate Planning Review
- Drafting The Durable Power Of Attorney For Wealth Protection Purposes
- Estate Planning For Pet Owners
- Remarriage Situations Can Raise Special Estate Planning Considerations
- Six Proven Estate Planning Techniques
- Special Needs Trust - An Estate Planning Tool For The Disabled
- The Limited Liability Company -A Sophisticated Tool For Estate Planning
- Using Trusts To Maximize Family Protection And Minimize Estate Tax
- Why Living Wills- Advance Directives Are An Essential Part Of Estate Planning